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PP RUEHDBU RUEHIK RUEHLN RUEHPOD RUEHSK RUEHVK RUEHYG
DE RUEHKV #0421/01 0651108
ZNR UUUUU ZZH
P 061108Z MAR 09
FM AMEMBASSY KYIV
TO RUEHC/SECSTATE WASHDC PRIORITY 7421
INFO RUCNCIS/CIS COLLECTIVE PRIORITY
RUEHZG/NATO EU COLLECTIVE PRIORITY
RUEATRS/DEPT OF TREASURY WASHINGTON DC PRIORITY
RUCPDOC/DEPT OF COMMERCE WASHINGTON DC PRIORITY

UNCLAS SECTION 01 OF 03 KYIV 000421

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DOE FOR LEKIMOFF, CCALIENDO, KBOURDREAU

E.O. 12958: N/A
TAGS: ENRG EFIN EPET PGOV PINR PREL RS UP

SUBJECT: UKRAINE: NAFTOHAZ PAYS GAZPROM AND AVOIDS A NEW CONFLICT, FOR NOW

Ref: Kyiv 419

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Summary

¶1. (SBU) On March 5 Naftohaz paid Gazprom in full for gas delivered in February. The payment of $360 million averted a possible repeat of the recent gas crisis after Russia had threatened to cut off deliveries if Naftohaz failed to pay by the March 7 deadline. Naftohaz paid despite its worsening financial situation, caused in part by government regulations forcing it to sell gas below cost, and in part by a drop in its customers' payment discipline in the wake of Ukraine's deepening financial crisis. Looking forward, Naftohaz's financial situation can only get worse, and it may struggle month-by-month to service its debt to Gazprom in a timely manner. Ukraine will have sufficient foreign exchange to pay its gas bills to Russia, however, and the GOU has created a mechanism that provides Naftohaz with the dollars it needs to pay Gazprom. The solution only redistributes Naftohaz's problems, however, and weakens both the central bank and the banking system as a whole. Ultimately the GOU will need to take painful decisions that will allow Naftohaz to operate efficiently and service its debts without resorting to financial alchemy. End summary.

Naftohaz Pays Its Debts on Time

¶2. (SBU) The Russia/Ukraine gas agreement stipulates that gas delivered in a particular month must be paid for by the 7th of the following month. If Naftohaz fails to pay on time, the agreement foresees that it will subsequently be required to pay for each month's deliveries in advance. Pre-payment would pose a notable economic burden on Naftohaz, which is already facing a tight liquidity situation on account of the economic crisis.

¶3. (SBU) Acting Naftohaz Head Ihor Didenko told us on March 5 that the company had now paid Gazprom for February deliveries. Didenko said Naftohaz paid $360 million in total. Later on March 5 the media quoted a Gazprom spokesman as confirming that Gazprom had received the payment.

Russia Threatens To Cut off Gas

¶4. (SBU) In recent weeks, both GOR and Gazprom officials had publicly stated that Gazprom would cut off deliveries to Ukraine if Naftohaz failed to pay by March 7. On March 5 PM Putin expressed concern that the March 4 SBU raid on Naftohaz (reftel) might disrupt Naftohaz's ability to pay, and cautioned that Russia could in fact

cut off gas to Ukraine, and consequently to the rest of Europe, if Naftohaz failed to service its debt in a timely manner. It is unclear whether the gas agreements actually permit Russia to cut off supplies so swiftly, as the agreements already contained a sanctions mechanism with the prepayment requirement.

Naftohaz's Financial Woes Deepen

¶5. (SBU) The Russian threats arose after Naftohaz reported in February that it was facing liquidity problems. Commentators in both Ukraine and Russia assumed that this could imperil Naftohaz's ability to pay its debts to Gazprom. The concerns were not unfounded. In recent years, Naftohaz's financial situation has continuously deteriorated as a result of GOU regulations that force it to sell gas below cost to large parts of the domestic market. In recent weeks, its problems have been compounded by a sharp drop in payment discipline. The company reported that its customers, primarily regional heating utilities, were only paying for about sixty percent of gas delivered by Naftohaz, whereas collection rates were over 90 percent in 2008. Utilities, in turn, had reported that payments for heating services had dropped because many households could or would not pay on account of the growing economic crisis in Ukraine.

¶6. (SBU) While the threat of another outbreak of the Russia/Ukraine gas war has been averted for now, Naftohaz's ability to pay Gazprom will be a recurrent issue in the coming months, as it is expected that Naftohaz's financial problems will only become worse. Analysts in Kyiv now expect Ukraine's economy to contract by between 5 and 10 percent this year. This will likely lead to a further deterioration in payment discipline, and increased liquidity problems at Naftohaz.

The nearly fifty percent decline in the $/hryvnia exchange rate has almost doubled Naftohaz's debt burden to Gazprom, because the company pays in dollars for imported gas but receives hryvnia for the gas it subsequently sells on the domestic market. Direct subsidies from the budget have kept Naftohaz afloat in recent years, and this year the budget foresees subsidies equal to about one percent of GDP. The GOU's ability to plug Naftohaz's financial hole will be severely restricted this year, as it is already struggling to fulfill the IMF's budget conditionalities and is also facing a budget deficit that probably cannot be financed without significant external financial support.

Despite Problems, Payments to Gazprom Appear Manageable

¶7. (SBU) Although its financial difficulties will remain, Naftohaz's ability to service its debt to Gazprom this year nonetheless appears manageable if the country's IMF program remains on track. From a pure balance of payments perspective, Ukraine will have sufficient foreign reserves to pay the debt. Most analysts expect the country's current account balance, which turned sharply negative in recent years, to be balanced or even slightly positive this year, as imports plummet and exports become more competitive on the back of a weaker hryvnia. This means that export revenues will generate enough foreign exchange to cover all imports, including gas imports from Russia, which together with oil imports only account for about 30 percent of Ukraine's imports.

¶8. (SBU) However, Naftohaz will still need to get access to foreign exchange, but this appears to be guaranteed as well after the GOU late last year established a mechanism that allowed Naftohaz to tap into the central bank's foreign reserves to pay off a $1.5 billion debt to Gazprom on December 30. It appears that this mechanism was used, at least partially, to allow Naftohaz to pay the debt for February gas deliveries as well, since it was reported that the NBU sold $150 million to Naftohaz last week.

¶9. (SBU) Under this mechanism, the National Bank of Ukraine (NBU) loans hryvnia funds to the state-owned banks Ukreximbank and Oschadbank. These banks in turn loan money to Naftohaz. In December the CabMin increased the capital of both banks to ensure that they could continue to meet capital adequacy requirements while

increasing their credit exposure to Naftohaz. Naftohaz, in turn, uses the liquidity from the two banks to purchase dollars from the NBU. Normally, only banks can engage in foreign exchange operations with the NBU, but in December the CabMin passed yet another resolution allowing Naftohaz to purchase dollars directly from the NBU in circumvention of the currency market. The NBU confirmed at the time that it had sold dollars directly to Naftohaz at its official rate, which at the time was significantly lower than the true market rate. Naftohaz then used the dollars to pay off its $1.5 billion debt to Gazprom.

¶10. (SBU) The mechanism has its risks, but can be employed repeatedly in coming months under certain conditions. Most importantly, it can work as long as foreign exchange reserves are not depleted too quickly. This will most likely be the case if Ukraine gets its IMF loan program back on track. The program foresees further disbursements of about $9.4 billion this year, but a tranche scheduled for disbursement in February has yet to be paid out because of Ukraine's continued inability to fulfill IMF conditionalities. The state-owned banks will need sufficient capital to provide further loans to Naftohaz, but this does not appear to be an obstacle after the capital increases in December.

Comment

¶11. (SBU) Ultimately, Ukraine cannot continue to finance its gas imports in this manner. The mechanism reshuffles and redistributes Naftohaz's problems, but does not eliminate them. It forces the NBU to trade scarce and valuable reserves for hryvnia-based claims against the state banks, and ultimately against Naftohaz. The loss of reserves and Naftohaz's perilous financial state weaken both the central bank and the state banks, and if the scheme is continued for too long it could drag the state banks deeper into Naftohaz's woes. In the end, Ukraine will have no choice but to create an environment where Naftohaz can operate profitably. This will entail painful reforms that include raising domestic gas prices to cost-recovery levels, and reforms that will create more efficiency and transparency in both the gas sector as a whole and at Naftohaz. End comment.

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